allowed amount (5 percent), they must show the charged price was above the cost of providing the service.[107]

The basket and band policy thus sought to glean the benefits of truly variable prices, such as increased efficiency and more innovative service, while preventing some of the perceived harms that would come from a completely deregulated approach. However, the policy as adopted did receive significant criticism from the LECs, which argued that the FCC had not set the balance properly by making the range of pricing too narrow.[108] This jeopardized the ability of the LECs to meet the efficiency targets that the FCC had set out. Because under the new regime the LECs' profitability was defined by whether they met (or exceeded) these targets, it was a serious concern.

IV. SUBSEQUENT MODIFICATIONS TO THE ORIGINAL PRICE CAP SCHEME

As originally envisioned, price caps were to introduce market forces into telephone pricing. In practice, however, the FCC proved less willing to leave LECs and consumers to market disciplines and incentives. This section describes various ways in which the original price cap regime was modified—often in ways that seemed to regress to the discredited principles of rate-of-return regulation.

A. *The FCC Repeatedly Increased the Productivity Factor and Retroactively Adjusted Earlier Period Indexes to Account for the Higher Productivity Factors*

Initially, the FCC's data led it to conclude that the Factor should be 3.3 percent because that figure best reflected the agency's empirical studies about how much LEC productivity increases had surpassed those of the general economy.[109] The agency, however, modified that initial conclusion. In 1995, the FCC increased the basic X-Factor from 3.3 percent to 4.0 percent.[110] Most recently, the Commission voted in May 1997 to require a new X-Factor of 6.5 percent.[111]

107. *Id.*

108. *Id.*

109. *Id.* para. 100.

110. *Price Cap First Report and Order*, *supra* note 67, para. 209. As with the initial system, the Commission again allowed carriers to choose among various X-Factors—4.0%, 4.7%, or 5.3%—each corresponding to a different sharing obligation. *Id.* paras. 214-15. This decision was subsequently upheld by the D.C. Court of Appeals in *Bell Atlantic Telephone Company v. FCC*, 79 F.2d 1195 (D.C. Cir. 1996).

111. *Price Cap Fourth Report and Order*, *supra* note 52, para. 18. In this *Order*, the Commission adopted the single 6.5% X-Factor and eliminated sharing.

The agency's explanation for raising the X-Factor to 6.5 percent was that it had adopted a new method for calculating the productivity factor.[112] Rather than simply relying on historic data, the FCC switched to a consideration of what it called "total factor productivity" (TFP), which examined the ratio of total output to total input.[113] Output and input are measured by indices, with the output index representing the quantities of goods and services produced, and the input index measuring the quantities of capital, labor, and materials used in production.[114] The goal of a TFP analysis is "to isolate the real change in productivity."[115]

In addition to raising the X-Factor to 6.5 percent, the FCC, in 1997, retroactively adjusted earlier period indexes to account for the higher productivity factors. The Commission required each LEC to adjust its price cap index effective July 1, 1997, to the levels for the 1997-1998 tariff year that would have been in effect had the agency adopted the 6.5 percent X-Factor in time for the LECs' 1996 annual filings.[116] The reason for this retroactive change was that the FCC believed the interim productivity factor of 4.0 percent adopted in 1995 "understate[d] LEC industry productivity growth."[117] Consequently, the agency concluded "that allowing all of the past two years of understated productivity to become permanently ingrained in LEC [price cap indices] would not strike the proper balance between stockholder and ratepayer interests."[118] The Commission thought carriers had notice that the 4.0 percent productivity factor was only interim, and thus the FCC believed it was reasonable to adjust the price cap retroactively to apply to the 1997-1998 tariff year.[119]

Carriers on both sides challenged the Commission's conclusion in the court of appeals. Long-distance carriers argued that the X-Factor had been set too low. Local carriers challenged the *Order* as a result-driven political deal with the long-distance carriers. Media reports at the time of the *Order* indicated that the Commission had reached a deal with AT&T under which AT&T would pass along certain access charge reductions to consumers.[120]

112. *Id.* para. 19.
113. *Id.* paras. 8-9.
114. *Id.* para. 9.
115. *Id.* para. 30. Under the old regime, changes in prices had a more pronounced impact on the X-Factor. Total factor productivity attempted to limit this effect.
116. *Id.* para. 179.
117. *Id.* para. 178.
118. *Id.* para. 179.
119. *Id.*
120. Ola Kinnander, *AT&T Puts Pressure on FCC to Reduce Access Charges More than Had Been Expected*, COMM. TODAY, May 6, 1997, at 1; John M. Broder, *AT&T to Lower Long-Distance Rates*, INT'L HERALD TRIB., May 5, 1997, at 15.

In exchange, the Commission would agree to cut access charges by $1.7 billion.[121] The local carriers argued that this "deal" led the Commission to manipulate the X-Factor data and apply it retroactively in order to reach the preordained reduction level.[122] The Commission responded that the Price Cap decision represented reasoned decision making based on the totality of a highly complex record. These issues are pending an appeal in the D.C. Circuit as of February 11, 1999.[123]

B. *The FCC Eliminated the Multiple Productivity Factor Choices*

Under the initial *Price Cap Order* in 1990, the agency had allowed the carriers to choose between different X-Factors: the standard one of 3.3 percent or a higher factor of 4.3 percent. Choosing a higher X-Factor demanded greater efficiency gains, but also offered a greater potential for profit.[124]

In 1997, after expanding the multiple X-Factor approach in 1995, the FCC decided that a higher X-Factor of 6.5 percent would be the only one permitted.[125] Carriers could no longer choose among different rates. The Commission's rationale was that: (1) most LECs had chosen the highest X-Factor; (2) the low-end adjustment mechanism was sufficient to address any heterogeneity existing among price cap LECs; and (3) permitting multiple X-Factors would attach differential sharing obligations that might undermine economic efficiency.[126] The FCC also thought that requiring a single X-Factor would simplify the FCC rules and prevent LECs from "gaming the system" by increasing profits without improving productivity growth by shifting between different X-Factor options.[127]

C. *The FCC Refused to Eliminate the Consumer Productivity Dividend*

The consumer productivity dividend, as originally conceived, was to compensate for anticipated gains in LEC productivity after the initial transition from rate-of-return regulation to price caps.[128] Consequently, many

121. *See supra* note 120.

122. Initial Brief for Local Exchange Carrier Petitioners at 7-13, United States Tel. Ass'n v. FCC, No. 97-1469 (D.C. Cir. Apr. 30, 1998) (on file with author).

123. United States Tel. Ass'n v. FCC, No. 97-1469 (D.C. Cir. Apr. 30, 1998).

124. *See supra* Part III.A.

125. *Price Cap Fourth Report and Order*, *supra* note 52, paras. 156-61.

126. *Id.* paras. 157-58.

127. *Id.* para. 159.

128. *See supra* Part III.B.

observers thought that the CPD would disappear once the transition took place.[129]

Instead, the FCC opted to retain the consumer productivity dividend. It disagreed that "the passage of time by itself has eliminated the need for a CPD. The CPD remains necessary to require LECs to transfer some portion to their unit cost reductions to their access customers. . . . The passage of time has not altered the need to strike this balance between ratepayer and shareholder interests."[130]

This explanation seemed cryptic if not curt. Perhaps thinking a more detailed justification necessary, FCC Commissioner Rachelle B. Chong issued a separate statement addressing this issue. Commissioner Chong said:

> I recognize that some have argued that the CPD was initially adopted as a way to flow through the first benefits of the price cap plan to access charge customers, and that it may be time to bid the CPD a fond farewell. Given the current state of competition in most price cap LEC markets, we have decided to continue use of the CPD as a way to ensure that productivity gains realized by the LEC will be shared between ratepayers and shareholders. In the future, however, a Commission may decide that competition has progressed to the stage where a CPD mechanism could be safely discarded because market forces will provide consumers with the benefit of the LEC's productivity.[131]

Yet Commissioner Chong's statement was more an acknowledgment of the problem than it was a justification. Few people would dispute that the FCC still must balance the interests of ratepayers and shareholders; but what was remarkable about the agency's explanation is how little it explained. The justification for the CPD's existence—the added productivity gains from the initial transfer to a price cap system—occurred almost eight years ago. Yet the FCC's official report never explained why "the passage of time" would not remove the need for the CPD. Logically, it would, and the agency's public statement gave no explanation about why this logic should not apply. Perhaps the Commission feared the abolition of sharing might create an unjust windfall to the LECs, but the higher X-Factor, crafted through a TFP analysis to gain the most accurate result, was designed to prevent that.

The agency's stated rationale for preserving the CPD was to ensure that efficiency savings flowed through to consumers, but the FCC had raised the X-Factor to do exactly that. The real question—left unanswered in the record—was why the newly increased and allegedly more accurate X-Factor did not obviate the CPD.

129. *See Price Cap Fourth Report and Order*, *supra* note 52, para. 125.

130. *Id.*

131. *Id.* (statement of Comm'r Rachelle B. Chong).

If the agency's objective was to pass efficiency savings along to consumers, raising the X-Factor or even retaining the sharing program would have accomplished that goal with a closer connection to the agency's stated policy goal and on a rational, reasoned basis. There was little need to muddy this already complex area of law by extending the CPD's lifetime without credible explanation.[132]

D. *The FCC Reduced Eligible Exogenous Costs*

In 1995, the FCC modified the original exogenous cost rules to deny exogenous treatment for accounting rule changes that do not affect a carrier's real economic costs.[133] The agency instituted an "economic cost standard" intended to limit exogenous cost treatment of cost fluctuations resulting from changes in the FCC's uniform accounting requirements.[134] Exogenous cost treatment was limited "to economic cost changes caused by administrative, legislative, or judicial requirements beyond the control of the carriers that are not reflected in the [Gross Domestic Product Price Index]."[135] The agency believed that "[b]y narrowing this exception, efficiency incentives should improve."[136] The concern was to avoid double counting.[137] Because the price cap index already was adjusted for inflation, the agency did not wish to include the same cost increase under both the inflation and the exogenous cost categories. To do so would grant the LEC additional profits without requiring any greater increases in efficiency.

In framing the new rule, the Commission focused on a LEC's discounted cash flows. According to the FCC, a change in accounting rules that affects a carrier's discounted cash flow represents a true change in economic costs and opportunity.[138] Thus, it should merit classification as an exogenous cost. On the other hand, a change in accounting rules that

132. On appeal, the agency argued for the first time that the extension of the CPD was needed due to the elimination of sharing. Without sharing, the Commission argued, carriers would have greater profit incentive to be efficient, making past productivity experiences with sharing consistently lower than could now be expected. The Commission's *Order* was cryptic at best on this point. The seeming post-hoc explanation for retention of the CPD led to charges by local carriers that the adjustment was retained as part of a political deal to lower access charges by a specific predetermined amount. *See generally* Initial Brief for Federal Communications Commission at 37-40, United States Tel. Ass'n v. FCC, No. 97-1469 (D.C. Cir. Apr. 30, 1998) (on file with author).

133. *Price Cap First Report and Order*, *supra* note 67, paras. 293-303.

134. *Id.* paras. 294-95.

135. *Id.* para. 294.

136. *Id.*

137. *Id.*

138. *Id.* para. 295.

does not affect discounted cash flow or opportunity costs should not be eligible for exogenous treatment.[139]

E. The FCC Eliminated Sharing but Not the Low-End Adjustment

At the same time it was tightening the eligibility for exogenous costs, the FCC in 1995 questioned whether it should continue to include a sharing mechanism in its price cap formula: "Based on our experience over the initial four years of LEC price cap regulation and the extensive record developed in this proceeding, we conclude that the sharing mechanism is not essential to ensuring that LEC rates under price cap regulation remain just and reasonable."[140] Although the FCC did not eliminate sharing at that time, it noted that a sufficiently high X-Factor could fulfill the same purpose of benefiting consumers.[141]

In 1997, the FCC formally removed the sharing requirement "as part of [its] overall strategy to devise a more deregulatory and efficiency-enhancing regulatory framework."[142] The agency believed that eliminating sharing removed a "major vestige" of rate-of-return regulation and in the future would facilitate more deregulation as local markets opened to competition.[143]

The Commission thought that the sharing system "severely blunt[ed] the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions."[144] If the LEC would not gain the profits from a remarkable increase in productivity, it had far less incentive to achieve tremendous productivity improvements. If a higher X-Factor created further incentives, however, the LECs would receive the marginal profits and thus had a strong incentive to continue to improve productivity. At the same time, consumers would benefit from the lower costs LECs charged long-distance providers for using the local network to complete an interstate telephone call.

The FCC, however, did not remove the low-end adjustment.[145] It feared that in its absence, the higher X-Factor might force the LECs to charge unreasonably low rates.[146] The profit cap on productivity improve-

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139. *Id.* paras. 294-95.

140. *Id.* para. 16.

141. *Id.*

142. *Price Cap Fourth Report and Order*, *supra* note 52, para. 146.

143. *Id.*

144. *Id.* para. 148.

145. *Id.* para. 11 ("To guard against our new X-Factor requiring individual LECs to charge unreasonably low rates, we will retain our current low-end adjustment mechanism.").

146. *Id.*

ments disappeared—the profit floor did not. Of course, the carriers still faced a much higher X-Factor and the retention of the CPD, but retention of the low-end adjustment did serve to limit any potential damage.

F. The FCC Modified New Services Pricing and Procedural Rules

"New services" are those that "add to the range of options already available to consumers. [They] may, but need not, include a new technology or functional capability."[147] New services are not included under the price cap indices until "the first annual price cap tariff filing after the completion of the base year in which the new service becomes effective."[148] Local exchange carriers may charge a "reasonable" level of the overhead costs of a new service.[149] New services subject to LEC price caps must be disclosed to the FCC with at least forty-five-days' notice; such disclosure must also be accompanied by a detailed cost report showing that "the LEC has used a consistent costing methodology for direct costs 'for all related services.'"[150]

In 1995, the Commission gave the LECs greater flexibility to lower prices within service category bands.[151] The lower pricing bands were expanded by an additional 5 percent to allow the LECs additional downward pricing flexibility.[152] Some critics had objected that this might increase the risk of predation, create unreasonable discrimination by departing from fully distributed cost pricing, and allow the LECs to abuse pricing flexibility to foreclose competitive entry.[153] The agency did not find these concerns compelling, and it concluded, "we believe that any increased risk of such conduct is outweighed by the benefits that consumers will receive from lower prices."[154] However, the FCC promised to "continue to review new services tariff filings for possible discrimination."[155]

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147. *Dominant Carriers Second Report and Order*, *supra* note 30, para. 314.

148. *Id.* para. 312.

149. Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture; Policy and Rules Concerning Rates for Dominant Carriers, *Report and Order & Order on Further Reconsideration & Supplemental Notice of Proposed Rulemaking*, 6 F.C.C.R. 4524, para. 38, 69 Rad. Reg. 2d (P & F) 641 (1991).

150. *Price Cap First Report and Order*, *supra* note 67, para. 394 (citation omitted).

151. *Id.* paras. 24-26.

152. *Id.* para. 26.

153. *Id.* para. 409.

154. *Id.* para. 410.

155. *Id.* para. 418.

G. *The FCC Began to View Price Caps Not as a Permanent Replacement for Rate-of-Return Regulation, but Rather as a Transition to Local Exchange Competition*

In 1995, the FCC undertook a "comprehensive review" of the LEC price caps, focusing specifically on whether the original policy goals should be modified.[156] The agency reaffirmed its conviction about the superiority of competition to regulation and its rationale for price caps: "[W]e adopted the current price cap system which, we believed, was not only superior to rate-of-return regulation, but could also act as a transitional system as LEC regulated services became subject to greater competition."[157] The goal was not merely to replace rate-of-return regulation but to "replicate the competitive outcome" present in the marketplace.[158] In that light, the Commission continues to believe price caps are a transitional device meant to allow the FCC to gradually reduce regulation as the LECs move from a fully regulated service to a competitive local exchange marketplace even if many of the implementation features of the FCC's regulatory regime suggest that the FCC views price caps as a more permanent fixture.[159]

In sum, the 1997 changes to the initial 1990 *Price Cap Order* were substantial: The X-Factor was raised significantly; the CPD was retained; sharing was eliminated; and multiple productivity factors were abolished.

V. EXPERIENCE WITH IMPLEMENTATION OF PRICE CAPS AT THE STATE LEVEL

Changes in LEC regulation are not limited to the federal government. In fact, some state legislatures and public utilities commissions were ahead of the FCC in adopting alternative regulatory plans for telecommunications companies.[160] The Commission noted that as of 1990, California, Illinois, Kansas, Michigan, New York, and Wisconsin had implemented variants of the price cap scheme.[161] Since then, other states, such as Alabama, Maine, North Carolina, Pennsylvania, South Carolina, Vermont, and Virginia have followed this lead.[162]

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156. *Id.* para. 5.

157. *Id.* para. 64.

158. *Id.* paras. 91-92.

159. Frank & Lazarus, *supra* note 67, at 27.

160. *Dominant Carriers Second Report and Order*, *supra* note 30, paras. 41-44. Fink, *supra* note 52, at 204.

161. *See supra* note 160.

162. *Re* South Central Bell Tel. Co., 164 Pub. Util. Rep. 4th (PUR) 324 (Ala. P.S.C. 1995); *Re* New England Tel. & Tel., 162 Pub. Util. Rep. 4th (PUR) 38 (Me. P.U.C. 1995); *Re* BellSouth Telecomm., Inc., 168 Pub. Util. Rep. 4th (PUR) 438 (N.C. U.C. 1996); *Re*

The price cap systems adopted at the state level are broadly similar to the FCC's regime. The division of services into baskets, for example, is an almost universal reaction to the problem posed by cross-subsidization. It is also common to find a productivity factor (an "X-Factor") to take into account the declining cost nature of the telecommunications industry. However, despite these general similarities, many of the state plans differ significantly from the FCC's structure. For example, several states apply different price caps to different service baskets. The state productivity factors are frequently much lower than that imposed by the FCC, and the use of a consumer productivity dividend (CPD or stretch factor) is quite rare at the state level. In fact, California, one of the few states that initially adopted such a factor, recently eliminated it. The extensive state experiences with price caps should inform any analysis of possible price cap modifications. More specifically, states like California, which have a long history with price caps in a large market, may offer significant guidance for future FCC reforms.

A. *Some States Have Implemented Different Price Caps for Different Service Baskets*

When the FCC adopted an incentive-based system to regulate the largest LECs in 1990, it noted: "The productivity offset we have defined was selected on the basis of total company performance, not the performance of individual 'baskets' of services or on a service-specific basis."[163] Thus, the FCC applied the same productivity offset and price cap structure to all of the services offered by the LECs, regardless of their basket grouping. Some states have rejected this universal, one-size-fits-all approach and have instead created different price caps for different service baskets, generally easing price cap restrictions in areas where competition has either already developed or is in the process of doing so.[164]

In South Carolina, for instance, the Public Service Commission approved a plan that divided the LEC's services into three baskets: basic, in-

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Implementation of Chapter 30 of the Public Utility Code, Streamline Form of Regulation M-00930483, 1995 WL 809963 (Pa. P.U.C. Apr. 13, 1995); *Re* BellSouth, 169 Pub. Util. Rep. 4th (PUR) 144 (S.C. P.S.C. 1996); *Re* New England Tel. & Tel., 157 Pub. Util. Rep. 4th (PUR) 112 (Vt. P.S.B. 1994); *Re* Telephone Regulatory Methods, 157 Pub. Util. Rep. 4th (PUR) 465 (Va. S.C.C. 1994).

163. *Dominant Carriers Second Report and Order*, *supra* note 30, para. 210.

164. *Re* South Central Bell Tel. Co., 164 Pub. Util. Rep. 4th (PUR) at 324; *Re* Bell Atl.-Washington, D.C., Inc., 173 Pub. Util. Rep. 4th (PUR) 55 (D.C. P.S.C. 1996); *Re* Alternative Forms of Regulating Tel. Cos., 174 Pub. Util. Rep. 4th (PUR) 120 (Md. P.S.C. 1996); *Re* BellSouth Telecomm., Inc., 168 Pub. Util. Rep. 4th (PUR) at 438; *Re* BellSouth, 169 Pub. Util. Rep. 4th (PUR) at 144.

terconnection, and non-basic.[165] Both the basic and interconnection service baskets are governed by a three-year rate freeze, after which they may be increased by the amount of inflation (determined by the Gross Domestic Product-Price Index (GDP-PI)), less a 2.1 percent productivity factor.[166] However, the price of services in the non-basic basket, which includes services that are deemed to face competition from other sources, may be raised by as much as 20 percent in any given twelve-month period, after the expiration of a five-year rate freeze.[167]

Alabama has adopted a very similar structure that also uses three baskets called basic, interconnection, and non-basic.[168] The basic category, which includes all of the services necessary for either a business or residential consumer to make a local call, is capped for five years, after which South Central Bell and any other LEC adopting this regulatory plan can increase prices by the GDP-PI minus a set productivity factor of 3 percent for South Central Bell and 1 percent for non-South Central Bell LECs.[169] The Commission further ruled that intrastate interconnection services would be tied to the interstate rates set by the FCC, reduced by 2.5 cents per minute (phased in over a three-year period).[170] The price of non-basic services, after a freeze of twelve months, may be raised by as much as 10 percent per year.[171]

In North Carolina, the Utilities Commission split the LECs' services into five, rather than three, different baskets: basic, non-basic 1, non-basic 2, interconnection, and toll switched access.[172] The Commission applied a cap of GDP-PI minus a 2 percent productivity factor to the basic basket, a cap of GDP-PI minus 3 percent to the non-basic 1 and interconnection baskets, a total freeze on prices in the toll switched access group, and left the prices in the non-basic 2 group unregulated, allowing the LECs total pricing flexibility in that area.[173]

Finally, in Washington, D.C., the Public Service Commission has adopted a three-basket approach, dividing LEC services into basic, discre-

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165. *Re* BellSouth, 169 Pub. Util. Rep. 4th (PUR) at 144.

166. There is also a 5% band similar to the one used by the FCC, described *supra* Part III.F.

167. *Re* BellSouth, 169 Pub. Util. Rep. 4th (PUR) at 144.

168. *Re* South Central Bell Tel. Co., 164 Pub. Util. Rep. 4th (PUR) at 324.

169. *Id.* at 333.

170. *Id.* at 335.

171. *Id.* at 334-35.

172. *Re* BellSouth Telecomm., Inc., 168 Pub. Util. Rep. 4th (PUR) 438 (N.C. U.C. 1996).

173. Non-basic 2 includes Centrex, billing, and collection services. Basic is defined as those services necessary to make a local call, and non-basic 1 is the catch-all category. *Id.* at 471.

tionary, and competitive.[174] The basic basket is restricted to an increase of GDP-PI minus 3 percent, while prices for discretionary services may be increased up to 15 percent per year.[175] Services defined as "competitive" are not subject to any pricing restrictions; prices in that category are entirely subject to the discretion of the LEC.[176] As with the other states, the D.C. Commission decided that the presence of competition in the market for certain services justified the removal of price regulation, as the free market would be able to adequately control the prices of these services.

It should be pointed out that these decisions all post-date the initial FCC implementation of price caps in 1990 by at least five years, and that by 1995, it was far more apparent that competition would become a feature of the LEC landscape than it had seemed in 1990. The FCC itself recognized this, by stating that the flexibility offered by price caps "gives the LECs the ability to adjust their prices to a limited extent in response to competitive entry."[177] There have, however, been two major overhauls to the FCC price cap system since it was first announced, in 1995 and 1997; in each case, the FCC declined to pursue a course similar to the one adopted by the states.[178]

B. *States Typically Set Much Lower Productivity Offsets than Those Used by the FCC*

The FCC began in 1990 by offering two different X-Factors, which brought with them different sharing requirements. These X-Factors were 2.8 percent and 3.8 percent, plus the addition of a 0.5 percent consumer productivity dividend, which brought the total to 3.3 percent and 4.3 percent.[179] In 1995, the number of X-Factors was increased to three, and the FCC continued with a 0.5 percent consumer productivity dividend, bringing the total offsets from 4.5 percent to 5.3 percent.[180] Last year, the FCC eliminated the multiple X-Factors, moving to a single, 6.0 percent figure, that yielded a total offset of 6.5 percent (when combined with the CPD).[181]

Despite the gradual increase in the total productivity offset that the FCC has favored, most states use X-Factors much closer to the 2.8 percent

174. *Re* Bell Atl.-Washington, D.C., Inc., 173 Pub. Util. Rep. 4th (PUR) 55 (D.C. P.S.C. 1996).

175. *Id.*

176. *Id.*

177. *Price Cap First Report and Order*, *supra* note 67, para. 4.

178. For a detailed discussion of the changes that the FCC made in 1995 and 1997, see *supra* Part IV.

179. *Dominant Carriers Second Report and Order*, *supra* note 30, para. 99.

180. *Price Cap First Report and Order*, *supra* note 67, para. 214.

181. *Price Cap Fourth Report and Order*, *supra* note 52, para. 144.

figure (without the CPD) initially used by the FCC as its lowest offset. States with X-Factors in this range include Kansas (3.0 percent), Pennsylvania (2.93 percent), North Carolina (2.0 percent), South Carolina (2.1 percent), and Alabama (3.0 percent); the District of Columbia also uses a 3.0 percent offset.[182] Maryland ties its X-Factor to a three-year average of the Consumer Price Index, which recently has averaged approximately 3 percent.[183] Indeed, a survey of all states that have adopted productivity factors, cited by the Kansas Corporation Commission, reveals that the national average is 2.6 percent.[184]

C. *The Use of a Consumer Productivity Dividend, in Addition to the X-Factor, Is Uncommon at the State Level*

While there is almost universal recognition among the states that an X-Factor is required to take into account the productivity differential between LECs and the rest of the economy, states use a consumer productivity dividend or "stretch" factor much less frequently. Illinois is an example of the rare case, using a 1 percent consumer productivity dividend that is added to the differential productivity growth measure (the X-Factor).[185] However, unlike the FCC's X-Factor, which is 6 percent, Illinois' X-Factor is only 1.3 percent.[186] Many states, like California, have eliminated this stretch factor based on their analysis of the potential efficiency gains now available to carriers.

For example, Kansas has decided that the inclusion of a stretch factor is not appropriate.[187] Dismissing the FCC's decision to include such a dividend as unpersuasive, the Kansas Corporation Commission found that a stretch factor would not produce any benefit: "The LECs have existing incentives to achieve the greatest possible efficiencies."[188] The Commission

182. *Re* South Central Bell Tel. Co., 164 Pub. Util. Rep. 4th (PUR) 324 (Ala. P.S.C. 1995); *Re* Bell Atl.-Washington, D.C., Inc., 173 Pub. Util. Rep. 4th (PUR) 55 (D.C. P.S.C. 1996); *Re* Telecommunications Industry, No. 190, 492-U, 94-GIMT-478-GIT, 1996 WL 938814, at *9 (Kan. S.C.C. Dec. 27, 1996); *Re* Alternative Forms of Regulating Tel. Cos., 174 Pub. Util. Rep. 4th (PUR) 120 (Md. P.S.C. 1996); *Re* BellSouth Telecomm., Inc., 168 Pub. Util. Rep. 4th (PUR) 438 (N.C. U.C. 1996); *Re* Implementation of Chapter 30 of the Public Utility Code, Streamline Form of Regulation M-00930483, 1995 WL 809963 (Pa. P.U.C. Apr. 13, 1995); *Re* BellSouth, 169 Pub. Util. Rep. 4th (PUR) 144 (S.C. P.S.C. 1996).

183. *Re* Alternative Forms of Regulating Tel. Cos., 174 Pub. Util. Rep. 4th (PUR) at 120.

184. *Re* Telecommunications Industry, 1996 WL 938814, at *16.

185. Illinois Bell Tel. Co. v. Illinois Commerce Comm'n, 669 N.E.2d 919, 927 (Ill. App. Ct. 1996).

186. *Id.*

187. *Re* Telecommunications Industry, 1996 WL 938814.

188. *Id.* at *16.

went on to set the X-Factor at 3 percent, which it felt was in line with the average of 2.6 percent used in other states.[189]

The Public Service Commission in Maryland made a similar decision in *Re* Alternative Forms of Regulating Telephone Companies.[190] There, the Commission adopted a rate regulation plan broadly similar to the one used by the FCC, including baskets, bands, and a productivity factor. The Commission declined, however, to impose an additional stretch factor, concluding that the Consumer Price Index served as a reasonable "proxy for expected future productivity gains," and was thus all that was necessary.[191]

The Pennsylvania Public Utility Commission "specifically reject[ed] the inclusion of a stretch factor" in LEC price cap regulation.[192] In addition to concluding that a stretch factor added nothing to a properly determined X-Factor, the Commission was concerned that inclusion of a stretch factor might actually damage the accuracy of the regulation.[193] It noted, "we are faced with both the uncertainty of the stretch factor theory and the relative imprecision of the estimated factor values available to us in this proceeding."[194] The Commission went on to conclude that an X-Factor of 2.8 percent was appropriate.[195]

Finally, California, which adopted a consumer productivity dividend when it first went to alternative regulation, has recently eliminated this stretch factor as a component of calculating the X-Factor.[196] The California Public Utilities Commission, in fact, engaged in a sweeping overhaul of its price cap system, which the FCC had once cited as being the "most similar" to the FCC's own regulations.[197] This reform not only eliminated the 0.5 percent stretch factor, it also froze the application of the price cap formula, which effectively equates the X-Factor to the GDP-PI.[198] This reduced the X-Factor from 5 percent to roughly 3 percent.[199] The California

189. *Id.*

190. *Re* Alternative Forms of Regulating Tel. Cos., 174 Pub. Util. Rep. 4th (PUR) 120, 120-62 (Md. P.S.C. 1996).

191. *Id.* at 120.

192. *Re* Implementation of Chapter 30 of the Public Utility Code, 1995 WL 809963, at *17 (Pa. P.U.C. Apr. 13, 1995) (citation omitted).

193. *Id.*

194. *Id.*

195. *Id.*

196. *Re* Incentive-Based Regulatory Framework for Local Exchange Carriers, 167 Pub. Util. Rep. 4th (PUR) 1 (Ca. P.U.C. 1995).

197. *Dominant Carriers Second Report and Order*, *supra* note 30, para. 42.

198. *Re* Incentive-Based Regulatory Framework for Local Exchange Carriers, 167 Pub. Util. Rep. 4th (PUR) at 1.

199. *Id.* at 1-6.

Commission concluded that the LECs had "achieved [all of] the easy gains by becoming highly efficient," and that while additional gains in efficiency were certainly possible, it was "unrealistic to believe that [LECs] can continue to realize additional efficiency gains at current levels."[200] Because of increased competition and the fact that "simple productivity gains realized in the initial years of price cap regulation ha[d] come to an end," the use of a stretch factor was "no longer appropriate public policy."[201] The Commission was persuaded that the declining revenues shown by Pacific Bell were caused in part by an overly onerous obligation to reduce rates, which was prompted by an overly high X-Factor combined with the consumer productivity dividend.[202]

Thus, while solid consensus does not exist on the use of consumer productivity dividends among the states, several states have concluded for similar reasons that such a stretch factor is unnecessary if the productivity differential is properly determined. Moreover, a number of states have also determined that the inclusion of a stretch factor can do more harm than good by making the total obligation of LECs more arbitrary than it would otherwise be.

VI. EVALUATION OF THE PRICE CAP VOYAGE

As often happens, the difference between theory and practice does not become apparent except through years of experience. After eight years, all parties should have witnessed enough results to evaluate whether the theory of price caps was successfully implemented in practice and whether jettisoning rate-of-return regulation was a wise decision.

Massive criticism has been leveled at the FCC over the implementation of price caps from both LECs and access customers. Local exchange carriers, on the one hand, although preferring price caps to rate of return, would have the FCC make the entire scheme more flexible.[203] These LECs are not lobbying for access price increases, *per se*. Rather, they argue that they should be given the flexibility to shape their offerings in response to customer needs and competitive offerings.[204] Interexchange carriers, on the other hand, would have the FCC make the scheme more rigid.[205] In fact

200. *Id.* at 17.

201. *Id.* at 18-19.

202. *Id.* at 25.

203. *Price Cap Fourth Report and Order*, *supra* note 52, para. 161.

204. *Id.* paras. 165-67; *see also Price Cap First Report and Order*, *supra* note 67, paras. 71-72.

205. *See, e.g.*, *Price Cap Fourth Report and Order*, *supra* note 52, paras. 25-28, 37-38; *Access Charge Reform First Report and Order*, *supra* note 99, paras. 162-64.

they often make arguments that appear more aimed at repealing the entire system than at reforming it.[206]

All parties have argued that the Commission has often been slow to implement changes to price caps that reflect market and regulatory changes. The agency has dribbled these changes out over years, thus exacerbating regulatory uncertainty and undermining the very goals it hopes to achieve. For example, by the time of its four-year review in 1995, the FCC was already moving in the direction of adopting a total factor productivity measure for the X-Factor. The Commission was also considering the elimination of sharing. The four-year review contained requests for comments on both of these topics; however, the changes were finally implemented in 1997. In adopting price caps four years before, the Commission had been careful to develop a price cap system that could serve as a permanent regulatory replacement for rate of return. By the time of the review, the FCC had begun to speak of the price cap regime as affording the flexibility necessary for LECs to make the transition from being regulated utilities to competitive telecommunications service providers.

Who is right? Sifting through the rhetoric, the implementation of price caps at the federal level has had both its plusses and minuses. With the clear majority of states following the FCC's lead by moving to price caps for local services, the regulatory community obviously views price cap theory as conceptually appealing. Most of these policymakers appear to conclude that the positives outweigh the negatives. In fact, as described below, with some significant modifications to bring the program back in line with its underlying principles, these minuses would be even less problematic than they are today.

A. *The FCC's Price Cap Regulations Generated Substantial Benefits*

1. The Elimination of Sharing Bolstered the Efficiency-Producing Impact of Price Cap Regulation

The sharing concept has often been referred to by the FCC as a "backstop" mechanism to ensure that ratepayers were not being over-

206. Interexchange carrier arguments that access charges be prescribed based on "total service long run incremental costs" (TSLRIC) is nothing more than a demand that access rates be set in accordance with rate-of-return principles, thereby eliminating the last eight years' impact of incentive-based prices. *See* Access Charge Reform et al., *MCI WorldCom, Inc. Comments*, CC Docket Nos. 92-262, 94-1, RM-9210, at 22-27 (Oct. 26, 1998) (urging the FCC to base access charges on "forward-looking economic costs") (on file with author); *cf. Access Charge Reform First Report and Order, supra* note 99, paras. 294-95 (rejecting IXC requests that costs be prescribed according to TSLRIC).

charged because the FCC failed to accurately set the X-Factor.[207] In other words, it was thought to protect against an X-Factor that was set too low, and thus return "excess profits" to ratepayers to "correct" for this potential error.[208] Obviously, the concept has a clear rate-of-return flavor, where customers are given "refunds" of "excess earnings," except that with sharing, carriers "share" with ratepayers the profits that exceeded the "sharing zones."[209]

Since the theory behind price caps is to encourage carriers to become more efficient by allowing them to keep earnings that exceed the traditional rate of return by increasing output or reducing costs, the idea of requiring LECs to give back to ratepayers some of those "rewards" for becoming more efficient must have a dampening effect on the efficiency motivation of price caps. Although there is some question about how precisely a company can gauge its efficiency improvements, one might expect that, when sharing is eliminated completely, steps to improve efficiency can proceed full steam ahead with confidence that those steps will be fully rewarded.[210]

Interexchange carriers, of course, have criticized the elimination of sharing, claiming that this mechanism is still necessary, in part because they believe that the FCC has not set the productivity factor high enough.[211] These parties never appear to directly contest the premise that sharing has a dampening impact on efficiency.[212] Eliminating sharing also enables the FCC to jettison some regulatory requirements that are relics of the rate-of-return era retained solely because sharing requires a detailed examination of earnings. For instance, the FCC continues to be concerned about misassignment of costs, even though cost assignments have no im-

207. *Price Cap Fourth Report and Order*, *supra* note 52, para. 154.

208. *See supra* Part III.C.

209. In fact, the FCC itself has actually referred to sharing as a rate-of-return-like mechanism. *Price Cap First Report and Order*, *supra* note 67, paras. 186-88.

210. Several carriers had already elected the option of not sharing even prior to its elimination.

211. *See* Price Cap Performance Review for Local Exchange Carriers, *Petition for Limited Reconsideration or, in the Alternative, Clarification*, CC Docket No. 94-1, at 7 (filed May 19, 1995) (on file with author); Price Cap Performance Review for Local Exchange Carriers, *Petition for Expedited Partial Reconsideration of the Ad Hoc Telecommunications Users Committee*, CC Docket 94-1, at 5 (filed May 19, 1995) (on file with author).

212. AT&T has argued that a system of multiple X-Factors coupled with a sharing requirement would be, overall, more efficient economically than a single X-Factor with no sharing because it would allow LECs to select X-Factors that were closer to those appropriate for their individual circumstances. However, even AT&T acknowledges that, all other things being equal, sharing reduces a LEC's incentives to become more efficient. *See* Price Cap Performance Review for Local Exchange Carriers, *Comments of AT&T*, CC Docket 94-1, at 36 (filed Jan. 11, 1996) (on file with author).

pact in a price cap environment.[213] Eliminating such relics of the rate-of-return regime would reduce carrier costs and free up regulatory staff to concentrate on other issues.[214] Finally, sharing was believed necessary to prevent any gross underestimation of the X-Factor from creating excessive earnings. Such a buffer is less needed because the FCC is now convinced that the X-Factor is set at the right level.[215]

2. Price Caps Have Led to Substantial Rate Decreases that Have Benefited Long-Distance Carriers

Access prices for price cap carriers have declined by over 45 percent during the last eight years, arguably price caps' most significant achievement.[216] Most of these declines can be attributed to the consistent downward pressure of the X-Factor. The rest is due to a mixture of exogenous cost adjustments and the sharing mechanism. The new 6.5 percent X-Factor is expected to decrease rates by over $1.7 billion a year.[217]

Interexchange carriers have claimed that access charges should have declined even faster.[218] However, the real deterrent to attaining realistic access pricing has been the continued existence of persistent subsidies in those prices.[219] Furthermore, rate-of-return regulation could do no better at eliminating these subsidies and certainly could not have been expected to decrease rates faster than did price caps. Therefore, reform of the lingering subsidies in access pricing and realistic universal service funding mechanisms are the real solution to these IXC concerns.

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213. *See* Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services, *Notice of Proposed Rulemaking, Order on Remand, and Waiver Order*, 11 F.C.C.R. 16,639, paras. 93-126, 9 Comm. Reg. (P & F) 2151 (1996).

214. *See* Position Paper of Arthur Andersen LLP, *Accounting Simplification in the Telecommunications Industry (ex parte)*, at 11, 17-18 (filed July 15, 1998) (on file with author).

215. *See Price Cap Fourth Report and Order*, *supra* note 52, para. 149.

216. INDUSTRY ANALYSIS DIVISION, FEDERAL COMMUNICATIONS COMMISSION, TRENDS IN TELEPHONE SERVICE 4 (July 1998).

217. Initial Brief for Local Exchange Carrier Petitioners at 6, United States Tel. Ass'n, v. FCC, No. 97-1469 (D.C. Cir. Apr. 30, 1998) (on file with author).

218. *See, e.g.*, *Price Cap Fourth Report and Order*, *supra* note 52, paras. 71-72.

219. Even the FCC has recognized that it has not yet wrung all subsidies out of access pricing, even though section 254 of the Communications Act required it to do so. *See Access Charge Reform First Report and Order*, *supra* note 99, paras. 29-32, *aff'd*, Southwestern Bell Tel. Co. v. FCC, 153 F.3d 523 (8th Cir. 1998).

3. Price Cap Regulation Has Simplified the Documentation that Must Be Filed with, and Has Streamlined the Evaluation of, Price Changes

One of the corollary benefits of price cap regulation is that it has substantially eliminated much of the paperwork associated with rate-of-return regulation. Because price cap regulation focuses only on the movement of prices, a detailed showing of costs is no longer necessary. Therefore, the only support material required is a demonstration of how the price movement is within the appropriate service category band and whether aggregate price changes within a basket are below the price cap index. This has reduced paperwork for individual rate filings.

Along with the reduced paperwork comes a streamlined review of such changes. It is obviously easier for the regulator to confirm that price movements are within band and below cap than to conduct a detailed examination of cost support materials. This will have even more of an impact on the state level, where full trial-type hearings have often been conducted to evaluate rate-of-return showings.

Although there has been a significant upsurge in investigations under the price cap regime from the rate-of-return regime, this seems to be the product of two more recent phenomena, rather than as a result of price caps. First, the Commission has instituted an unprecedented number of regulatory changes in the access pricing context over the last eight years, much of which surrounds the promotion of competition.[220] Second, the Commission has become a more aggressive regulator in the last few years supported by more sophisticated tools to conduct rate investigations.[221] These same two factors appeared to be the cause of increased investigative activity even during the latter half of the 1980s, when rate-of-return regulation was still in vogue.[222]

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220. *See, e.g.*, Expanded Interconnection with Local Telephone Company Facilities, *Memorandum Opinion and Order*, 9 F.C.C.R. 5154, 75 Rad. Reg. 2d (P & F) 1040 (1994); Transport Rate Structure and Pricing, *Report and Order and Further Notice of Proposed Rulemaking*, 7 F.C.C.R. 7006, 71 Rad. Reg. 2d (P & F) 567 (1992).

221. The FCC's use of computerized auditing and statistical programs to evaluate carrier data makes an investigation possible since it can be done without traveling on site and poring through massive carrier records. *See, e.g.*, Common Carrier Bureau Solicits Comments on Proposed Modifications to ARMIS 43-07 Infrastructure Report, *Public Notice*, 8 F.C.C.R. 7130, 73 Rad. Reg. 2d (P & F) 1017 (1993); 800 Database Access Tariffs and the 800 Service Management System Tariff and Provision of 800 Services, *Report and Order*, 11 F.C.C.R. 15,227, 4 Comm. Reg. (P & F) 1279 (1996).

222. *See, e.g.*, Investigation of Access and Divestiture Related Tariffs, *Memorandum Opinion and Order*, CC Docket No. 83-1145, Phase I and Phase II, Part 1, 1986 WL 292562 (1986); Investigation of Special Access Tariffs of Local Exchange Carriers, *Memorandum Opinion and Order*, CC Docket No. 85-166, Phase I, 1986 WL 291617 (1986).

B. *The FCC's Implementation of Price Caps Suffered from Significant Shortcomings*

1. Politicizing Price Caps Has Undermined the Consumer Benefits that Can Be Achieved

The strength of any economic incentive regulation is that it lends predictability to the marketplace. Price cap regulators, in their brief eight-year existence, have seemingly ignored this maxim. Indeed, the FCC has already revisited the price cap regulatory regime twice in its short history.[223] In each of these cases, the agency has not only altered the regulatory regime going forward, but has also reached back to "correct" perceived errors or oversights in the previous regime through retroactive application of the newly revised X-Factor. Yet the core appeal of price cap regulation is that it provides an incentive for carriers to achieve higher efficiencies and thus higher profits by exceeding predefined efficiency goals.[224] By making these incentives uncertain, or altogether illusory, the Commission has undermined one of the core appeals of the price cap system.

The most extensive, and most damaging, alterations to the price cap regime have come in the form of repeated increases and retroactive changes in the X-Factor. As set out above, the original 1990 price cap indices were set at 3.3 percent (with sharing) and 4.3 percent (without sharing obligations). These indices remained in effect until 1995, when the Commission issued its Price Cap Performance Review.[225] In the review, the Commission not only scrapped the existing indices, but reached back to apply those indices to the 1990-1994 period. First, the Commission instituted a prospective three-level price cap regime with X-Factors of 4.0 percent (with sharing), 4.7 percent (with reduced sharing obligations), and 5.3 percent (with no sharing).[226] Second, the Commission determined that those carriers that had selected the 3.3 percent X-Factor for any of the years 1990 to 1994 would be forced to "reinitialize" their rates for that

223. *See Price Cap First Report and Order*, *supra* note 67, para. 199; *see also Price Cap Fourth Report and Order*, *supra* note 52.

224. Indeed, even the Commission, at least publicly, has embraced the notion that individual carriers are entitled to excess profits if they achieve exceptional efficiency gains. In eliminating sharing, the Commission has noted that "[a] firm that is more efficient than its competitors in a competitive market has the option of not lowering its price and reaping higher margins on the units it sells at the prevailing market price," and that continuing "[s]haring would eliminate such an option." *Price Cap Fourth Report and Order*, *supra* note 52, para. 153.

225. *See Price Cap First Report and Order*, *supra* note 67.

226. *Id.* paras. 199-200.

year as if the carrier had been subject to a 4.0 percent X-Factor all along.[227] The retroactive application of these changes, of course, cannot affect LEC efficiency because the changes occurred after the fact. These unpredictable retroactive adjustments dampen efficiency incentives and upset business planning and expectations. By adjusting the X-Factor, the FCC is also engaged in back door rate-of-return regulation, a result the FCC said it was trying to avoid.

The 1997 *Order* furthered this disturbing trend by once again altering the prospective price cap index—this time by establishing a uniform 6.5 percent X-Factor for all carriers and eliminating the sharing requirement.[228] The 1997 *Order* also reinitialized rates for all carriers for 1996 by imposing a 6.5 percent X-Factor, regardless of the carriers' initial X-Factor election.[229] In total, for the first six years of the price cap regime carriers were able to enjoy the long-term benefits of their regulatory choices for exactly one year. These shifting regulatory sands meant that higher-than-expected productivity gains were greeted by regulators with higher X-Factors to take away these efficiency rewards—the exact rewards that were advertised to greet more efficient carriers as the core of the incentive-driven price cap regime.

The Commission has similarly disrupted expectations in the regulation of exogenous costs. For example, starting in 1992, companies were required to shift their accounting procedures to account for post-employment benefits other than pensions on an accrual basis. Several companies adjusted their caps accordingly, but the Commission attempted to disallow the modifications. The D.C. Circuit reversed the Commission because the existing rules had permitted the adjustment.[230] In response, the Commission promulgated a new rule to preclude recovery of future, amortized installments of other post-employment benefit costs.[231] Here too, the Commission has altered the rules repeatedly making carriers leery of any future decisions based on an unreliable regulatory regime.

Even the unscientific way in which the X-Factor has been established underscores the politicization of the X-Factor. Although some mathematical formula based on historic efficiency gains could be justified, the FCC has always adjusted these averages based on its "prediction" about future gains. For instance, in raising the X-Factor to 6.5 percent, the FCC arbitrarily tossed out 1992 from the average because it was "anomalously

227. *Id.* paras. 245-56.
228. *See Price Cap Fourth Report and Order*, *supra* note 52, paras. 157-58.
229. *Id.* paras. 177-81.
230. *See* Southwestern Bell Tel. Co. v. FCC, 28 F.3d 165 (D.C. Cir. 1994).
231. *See Price Cap First Report and Order*, *supra* note 67, para. 307 & n.578.

low," without convincing reasoning or evidence for that conclusion. The FCC failed to throw out anomalously high years and never explained why averaging results would not adequately correct for the low figures.[232] Failure to straightforwardly deal with these numbers gives credence to the political manipulation charges. Given that prediction is an art rather than a science, charges of political manipulation would not be possible if the FCC had simply used historical trends and been done with it.[233]

2. Price Caps Should Be Structured to Increase the Role of the Marketplace When Competition Is in Place

There is little question that the Commission needs to quit tampering with the inner workings of price cap regulation; the agency must also, however, limit the reach of the overall price cap regime to allow the open markets it ultimately desires to function properly. Two areas illustrate this latter concern: inadequate pricing flexibility and inclusion of new services. Both of these elements have served to delay the transition to an open competitive market. As the Commission itself has observed, "[e]conomic logic holds that giving incumbent LECs increased pricing flexibility will permit them to respond to competitive entry, which will allow prices to move in a way that they would not have moved were the pricing restrictions maintained. This can lead to better operating markets and produce more efficient outcomes."[234] Yet, the Commission has thus far failed to grant carriers these market-aiding reforms.

In its *Notice of Proposed Rulemaking* addressing price cap reform, the Commission seemed to be on the right track in considering regulatory alternatives that would have given LECs greater flexibility in pricing services while still reducing the overall price cap.[235] More specifically, the Commission proposed elimination of four regulatory constraints that would have permitted greater flexibility in pricing upon a showing by the carrier of potential competition. The proposal included lifting: (1) the prohibition on geographic deaveraging; (2) the ban on volume and term discounts for interstate access services; (3) the prohibition against contract

232. *See Price Cap Fourth Report and Order*, *supra* note 52, paras. 138-41.

233. The United States Telephone Association proposed one such unmanipulable average—a moving five-year average that would change each year based on the previous five-year average. *See id.* para. 35.

234. *See Access Charge Reform First Report and Order*, *supra* note 99, para. 270 (citation omitted).

235. *See* Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, *Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry*, 11 F.C.C.R. 21,354, 5 Comm. Reg. (P & F) 604 (1997) [hereinafter *Price Cap NPRM*].

tariffs and individual requests for proposals; and (4) various constraints on the ability of incumbent LECs to offer new, innovative access services.[236]

The Commission also proposed greater flexibility upon a showing that carriers faced actual competition. These reforms included: (1) elimination of price cap service categories within baskets; (2) removal of the ban on differential pricing for access among different classes of customers; (3) an end to mandatory rate structure rules for transport and local switching; and (4) consolidation of the traffic-sensitive and trunking baskets.[237] These proposals languish without action.

The Commission has still not developed a plan that relies on marketplace forces to drive interstate access prices to levels that would be achieved through competition. The market-based approach was supposed to give carriers greater flexibility in setting rates as competition develops. Notably, however, the agency did not even propose to rely on market forces to set rates for all access services; those services not currently subject to competitive pressures will be subject to a regulatory "safeguard" to bring the related access rates to competitive levels. For those services subject to competitive pressures, the FCC intends to provide detailed rules for implementing this market-based approach in the near future. In the meantime, proposals have surfaced that would take an even more prescriptive approach in light of the perceived competitive shortcomings of the current marketplace.[238]

The Commission's reluctance seems to be contrary to the stated goal of ultimately moving these services to a fully competitive price structure.[239] For example, geographic deaveraging would permit carriers to set prices based on smaller geographic units, therefore driving prices closer to costs. Geographic deaveraging would also correct the false signals that the current regulated market sends for these services. The current system averages out costs over large service areas and thus sets rates artificially high in some areas (thereby creating a perverse incentive for entry) and artificially low in other areas (thereby creating a perverse incentive against entry). Other proposals such as volume and term discounts also seem consistent with cost-based pricing and would spur more competitive pricing for these services, along with their obvious consumer benefits. Such cost-based reforms are consistent with the overall Commission policy of driving prices to costs and creating market-based rates.

236. *See id.* para. 168.

237. *See Price Cap Fourth FNPRM, supra* note 81.

238. *See id.*

239. *See supra* Part IV.G.

The *Price Cap Notice of Proposed Rulemaking* also considered the possibility of "whether price [cap] regulation of new services is still needed or warranted."[240] The *Price Cap Notice of Proposed Rulemaking* further observed that

> [m]any new services take advantage of new technical capabilities, and the delay entailed in obtaining regulatory approval may harm consumer welfare. Because the underlying core access service offerings, as well as unbundled network elements, would still be available, there may be little benefit from requiring an incumbent LEC to obtain regulatory approval before introducing a new service.[241]

The Commission also considered whether some services formerly subject to the waiver requirement could also be eliminated from price cap regulation "if competing carriers can develop substitute services to respond to customer needs."[242] Unfortunately, the Commission has deferred a decision on this issue as well. New services represent another fertile area for the FCC to roll back regulation because competition can be virtually assumed and lessened regulation will encourage innovation. Ultimately opening new service markets and granting increased pricing flexibility will encourage a transition to more open markets, innovation, and lower prices for consumers.

3. The Lack of a Pass-Through Requirement Imposed upon IXCs Has Undermined End-User Benefits

The long-term goal of price caps is to lower rates for consumers and this goal has, in part, been achieved. Lower access charges have resulted in some consumer gains. However, it still appears as if the regulatory scheme does not "flow through" access charge reductions to consumers unaltered. Instead, consumers only receive some percentage of the overall reduction. Indeed by one estimate while access charges fell by an average of 21 percent from 1993 to 1997,[243] AT&T's residential basic rates for long-distance carriers climbed 18 percent.[244] Moreover, pricing in the long-distance mar-

240. *Price Cap NPRM*, *supra* note 234, para. 199. The Commission had previously decided to loosen the tariff requirements on new service offerings. *Id.* para. 309.

241. *Id.* para. 199.

242. *Id.* para. 200.

243. *See FCC Monitoring Report, Table 5.12* (May 1997) <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/Monitor/mr97-5.pdf> (John Scott, Competitive Pricing Division, Federal Communications Commission (preliminary)).

244. *See AT&T Proposes $750 Million Rate Hike, New Calling Plan Aimed at High-Volume Residential Users*, TELECOMM. REP., Jan. 3, 1994, at 8 (announcing a 6.3% rate hike); *AT&T and Rivals Boost Rates Further*, WALL ST. J., Nov. 29, 1994, at A3 (3.7% rate hike); *AT&T to Raise Basic Prices an Average 40c a Month*, BLOOMBERG NEWS SERVICES, Feb. 16, 1996 (4.3% rate hike); *AT&T Follows MCI, Sprint with Long Distance Rate Increases*, TELECOMM. REP., Dec. 2, 1996, at 5 (5.9% rate hike); *Bill Harvesting II*, PNR &

ket, especially for residential users, is still largely a function of lock-step pricing among the big three: AT&T, Sprint, and MCI WorldCom.

In 1997, the FCC, not unaware of this phenomenon, secured a deal with AT&T to flow through access charge reductions to consumers.[245] Even this "deal" only flowed through half of the access charge reductions.[246] The Commission has voiced its belief that the market will eventually force carriers to flow through the benefits of reduced access charges to consumers.[247] However, until the long-distance marketplace forces increased flow through of these reductions or the Commission mandates such flow throughs, the full benefits of price caps will be lost to consumers.

C. *The Commission Should Reform Price Caps Consistent with Its Initial Goals and the Ultimate Destination of Full Competition*

The Commission can move in a common sense direction by returning price caps to first principles to ensure that the incentive-based structure is preserved and consumers enjoy the benefits of local carrier efficiency gains. The Commission should:

(1) simplify the X-Factor calculations to maintain their statistical integrity. This will limit charges of political manipulation and outcome-based regulation, while assisting all parties in providing relevant comment and data.

(2) adopt a single X-Factor and maintain it over the long haul to create firm incentives for LECs to become more efficient. This will lend predictability to price cap regulation and increase local carriers' ability to take advantage of the profit incentives, while allowing long-distance carriers and consumers to rely on lower fees.

(3) refrain from tinkering with the X-Factor itself or the calculation formula. Price caps are inherently imprecise. The Commission's constant tampering to "fix" this problem or that miscalculation has created a larger problem—complete unpredictability and constant uncertainty.

(4) refrain from making retroactive adjustments in the cap that deny LECs the benefit of their bargain. The entire regime is based on the ability to keep profits created by large efficiency gains; the subsequent reclama-

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Associates (indicating a 5.8% rate decrease in July 1997, and a 2.7% rate hike in November 1997). Cumulatively, these rate changes amount to an increase of 18% from 1993 to 1997.

245. *See* Kinnander, *supra* note 120, at 1. The deal itself has also drawn the ire of some carriers that believe the reductions in access charges were simply too steep.

246. *Id.*

247. *Price Cap Fourth Report and Order*, *supra* note 52, para. 185.

tion of these gains when doing so cannot alter the carrier's past efficiency, and undermines the core incentives of the regime.

(5) eliminate the consumer productivity dividend so that the cap reflects actual achievable efficiency gains. The CPD may have been necessary in the transition from a rate-of-return regime to price caps. That utility has now disappeared. An accurate X-Factor makes the CPD an anachronism.

(6) adopt an explicit pass-through requirement that will require long-distance carriers to pass through price cap reductions to consumers. This requirement is needed to guarantee that consumers enjoy the benefits of price cap reductions and eliminates the need for side deals to promote these policies.

In addition to these changes, the Commission should also use price caps as a transitional mechanism to the eventual free market. These changes include:

(1) increased pricing flexibility. As flexibility increases, the price cap regime moves closer to functioning like a true marketplace. This can be achieved while still reducing overall rates by the X-Factor. This flexibility could be achieved through such reforms as geographic deaveraging, permitting volume and term discounts, and the elimination of price cap service categories within baskets.

(2) placement of new services outside of the caps. The market for new services is largely competitive. In order to encourage innovation and transition to the free market, these services should be placed outside the price cap regime.

These changes can ensure that the promises of the price cap regulation voyage are achieved, while easing and speeding the journey to the fully competitive marketplace destination to which all parties purportedly aspire.

VII. CONCLUSION

In replacing rate-of-return regulation with price caps, the FCC adopted a system with great potential for finally bringing market forces to local telephone pricing. That initial promise, however, has not fully materialized due to well-intentioned, but ultimately misguided efforts to tinker with the price caps' course to competition. Although the price cap voyage has made substantial progress, the Commission would be well-served to return to its initial course in order to reach the destination of competition as soon as possible. Until the obstacles to market forces disappear, consumers will not experience the true benefits of the price cap system.